

Commercial Banking: One Industry?
Remarks by
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North Carolina Bankers Association Convention
Palm Beach, Florida
June 2, 2014

The United States has a long history of economic success under a decentralized and diversified banking structure. Commercial banks, ranging in size from very small to very large, have served the credit needs of individuals, small businesses and large international firms. In doing so, the sum of these financial institutions created and supported the largest most dynamic economy in the world.

Today, the regional and community bank component of this model remains very workable, wherein the banker serves as the trusted intermediary between savers with money to deposit and borrowers who need credit. Yet, in the past 30 years community banks have diminished in importance as has their share of the banking market. The financial industry, on its current path, is destined to evolve into one in which a few large financial firms and the government control the allocation of credit within the national economy. This also will result in a National economy with a diminished competitive position within the broader global economy and regions and rural communities with either poorer options for, or reduced access to, credit.

Today, the commercial banking industry largely blames regulatory burden – that is Congress and regulators – for current consolidation pressure. In today's remarks I will discuss the state of the industry and what I see as factors driving consolidation. I will conclude with my observation that the industry of commercial banking is responsible for the regulatory burden it faces, but – should it choose to do so – could reduce that burden, especially as it affects regional and community commercial banks.

State of the Industry

Within commercial banking, regional and community banks have become less influential as they are losing market share of credit allocation within the economy and are shrinking in numbers. An illustration of the consolidation of the credit channel within the U.S. is illustrated in the attached chart. In 1984, the distribution of assets among four size groups of U.S. banks was nearly proportional, with more than 15,000 commercial banks serving a variety of borrowers, from consumers and small businesses to global conglomerates.

Currently, as the chart shows, the group of banks with more than \$10 billion in assets controls more than 80 percent of industry assets, and the number of banking firms has declined to less than 7000. The group of banks with less than \$1 billion of assets in 1984, which once controlled nearly a third of banking assets, today controls less than 10

percent. This is a dramatically different structure, and whether it remains vibrant, competitive and able to serve the present and future needs of consumers and business is unfortunately unclear.

Factors driving consolidation

To judge whether ever-greater concentration of the financial industry is the inevitable result of market forces or something else, we need to think about what factors have contributed to this outcome. I start by identifying three drivers of this trend. First is the liberalization of branch banking laws. Around the time of the last crisis, in the mid 1980s, states began to permit branch banking. Hundreds of banks failed during that period, and to provide a mechanism by which failing banks could be acquired by other banks as a means to continue local banking services, state agencies and legislators expanded bank branching privileges within and sometime among states. Over time, the federal government expanded and extended branch banking in a series of legislative actions, eventually permitting full nationwide interstate banking by 1997. There can be little doubt that this development has been a major contributor to industry consolidation.

Second, in the late '80s through the '90s there was an effort within the commercial banking industry to expand its permitted activities to include insurance, investment banking, broker-dealer activities, and trading. This effort was codified in the Gramm-Leach-Bliley Act of 1999. Without the advantage of the safety net, FDIC insurance and Federal Reserve discount window loans, nonbank brokerage firms quickly found themselves at a competitive disadvantage and struggling to survive. It became apparent that unless they either merged with commercial banks or became more like commercial banks, they would be driven from the market. Again, the outcome was increased consolidation and concentration of resources reflected in the accompanying chart.

Third, the banking industry has been required to absorb a host of new rules and requirements that translate into a rising fixed cost of regulation. These costs include lawyers to interpret the regulations, along with training, hiring additional staff for implementation, and reacting to risk of violations. Like any fixed or nearly fixed cost, its impact per dollar of assets declines with asset size. Thus, there should be little doubt that regulatory burden contributes to the trend toward consolidation as smaller banks work to control costs and to survive within a highly regulated industry.

Changing Outcomes

If the goal, then, is to arrest this trend and retain a diversified banking industry that serves different elements of both local communities and global markets, and whose structure remains responsive to broad market forces rather than political agendas, then the question becomes: What must change? In answering this, it is useful to begin by acknowledging those factors contributing to consolidation that almost certainly will not change.

We can be confident, for example, that there is no interest from any source in ending commercial bank branching. Banks have come to depend on their branching capabilities to adjust to market and demographic shifts and to meet customer and market demands. Therefore, industry consolidation will continue to occur as markets change and competitive pressures demand.

Also, there is no interest in giving up the government's role in protecting customer deposits and the payments and settlements system, which are unique features of commercial banks of all sizes. This safety net serves to support public confidence in the system. However, some commercial banks have been permitted to extend the benefits of this safety net to activities beyond its original, limited purpose. This has provided an enormous competitive subsidy and has contributed to the further consolidation of the nation's credit channels. Given the consequences of this extended subsidy, it is legitimate to question whether this has been wise or appropriate. Explicit and implicit government guarantees encouraged excessive leverage and increased risk taking, and they led to the most recent crisis. Subsidies are not free.

Until the advantage for some commercial banks over others is remediated, regional and community banking will continue to shrink at an accelerated pace.

In addition, as the safety net has been exploited, the burden of more and more complex regulations was quick to follow. In looking back over the past decade it is an unfortunate fact that the current regulatory burden has been earned. Don't forget that a structured investment vehicle (SIV) was packaged to misrepresent the balance sheet and understate leverage. Or that collateralized debt obligations that contained unacceptable asset quality were sold into the market. Within the banking industry, there was mortgage manipulation, ROBO signing, LIBOR fixing, and commodities-price and energy-rate manipulation. Among the largest commercial banks, leverage ratios sometimes exceeded 30, 40 and even 50 to 1.

Yes, it may be convincingly argued that these misdeeds were committed by the most complex commercial banking firms, engaged in a host of non-commercial bank activities. However, community banks are commercial banks. And as commercial banks they are subject to the new rules and regulations, which for starters include: Basel international capital rules, QM, QRM, escrow requirements, balloon mortgages, compliance exams -- and the costs that come with each. Many claim that these provisions were not intended to apply to community banks. But in fact they were intended for commercial banks, which you are.

It is a common mantra of the industry today to hear "One Industry" in meetings or publications discussing regulatory burden. Therefore, it should surprise no one that the public and the Congress fail to distinguish community banks from other commercial banks that also are universal banks, with their array of investment banking, trading and other financial activities -- and with the panoply of abuses highlighted daily in the media. It, therefore, is a lot to expect of the public or the Congress to understand which

regulations should apply to some and not others when all receive the benefits of government protection.

What can be changed?

To have a chance at regulatory balance we - that is the industry and the regulators - must work to change the cause of the burden, which is to ensure we have the courage and ability to stop the missteps, and abuses that sometimes occurs in commercial banking. Confidence in the ability of the industry to manage and regulators to supervise effectively would justify efforts to have the Congress and regulators remove aspects of the industry's regulatory burden, and to do so without undermining economic stability or putting the public pocketbook at extended risk.

Is such a goal too ambitious; too unrealistic? Perhaps, but I am certain of one thing: If we continue on the path of more and not better regulation of a flawed system, consolidation for the wrong reason will continue. As Alan Greenspan recently noted, "JP Morgan is a Fannie Mae-, Freddie Mac-type of institution, because they are indeed too-big-to-fail, and taxpayer monies will come in behind them to hold them up if necessary."¹ Yet it is also true that, for all their legal travails, trading losses and enormous fines, the largest banking firms continue to gain in relevance and market power while community banks struggle. Rather than allow this to continue, we could choose to confine the safety net to commercial banking, as was intended.

Conclusion

The community bank business model is viable, but its success relies on a market system that is being undermined. To prosper as an industry, commercial banks must be allowed to compete and succeed or fail based on the fundamentals of commercial banking and individual bank performance. Community and regional banks are dying a slow death waiting for regulators to carve them out as special. Rather than rely on the hope of a "carve out," they should insist on discipline across the entire commercial banking industry. Commercial banking is not "one industry" as long as the largest banks are subsidized to a greater degree, and are allowed to have less capital², less robust supervision³ and more leverage than the remainder of the industry.

Consolidation of the Credit Channel: Change in Assets by Bank Size Groups (1984-2013)

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1May 14, 2014. Peter G. Peterson Foundation 2014 Fiscal Summit.

2Global Capital Index:

<http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q13.pdf>

3Financial Oversight: It's Time to Improve Outcomes" by Thomas M. Hoenig.

<http://www.fdic.gov/news/news/speeches/archives/2012/spnov3012.html>

Last Updated 6/10/2014